

Central Intelligence Agency



Washington, D.C. 20505

1 April 1985

Mr. Franklin J. Vargo
Deputy Assistant Secretary for Europe
US Department of Commerce

Dear Mr. Vargo:

1. As you requested, we have undertaken a number of economic simulations starting in mid-1985 on the West European countries to determine the impact of various policy alternatives on growth and other key economic variables. Attached are seven tables, each with the results of a specific simulation for Western Europe, and the other major countries.

2. Some key highlights and conclusions are the following:

- Tax cuts (personal income or business) are the most effective means to raise growth. Simulations using the money supply or interest rate as the policy variable produced no meaningful results for growth; in both cases the results directly impacted on prices and exchange rates. Our model, the Linked Policy Impact Model, produces results on an annual basis and cannot, therefore, easily take into account any real effects that quarterly models may capture.
- Tax cuts implemented by all West European countries to raise growth by two percentage points has the largest but not a dramatic impact on lowering unemployment; the 1.7 percentage point decline in 1987 from the baseline probably translates at most into a point decline in the current rate. At the same time, however, the deterioration in budget and current account balances is rather severe (Table 1).
- Tax cuts aimed at raising growth by only a percentage

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point appear tolerable in terms of their impact on budget deficits and current accounts, but unemployment winds up only 0.9 percentage point lower than the baseline; this would probably be enough to just stabilize the current unemployment rate (Table 2).

- The "locomotive" simulations whereby only the Big-4 stimulate (Tables 3, 4, and 5) produce similar results to the European-wide stimulation, but the burden also falls heavily on the Big-4; budget and current account deterioration is strong in West Germany, France and the UK, though the type of tax change affects each country differently.
- A West German-UK stimulation package is not greatly different from the Big-4 results. Unemployment ends up 0.6 percentage point below the baseline instead of 0.8; government and current account balances are also only slightly more affected (Table 6). The last simulation, whereby West Germany and the UK implement tax cuts in mid-1985 (The UK cut is twice the announced figure of \$800 million, and the West German cut of \$7.6 billion is now scheduled for 1986 and 1988) produces meaningful results only for West Germany, where the unemployment rate drops by almost a percentage point below the baseline.

3. Please feel free to contact me [redacted]
[redacted] if we can be of further assistance.

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Sincerely,

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Enclosure: as stated

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Table 1

Simulation 1: All West European Countries Raise Growth
Two Percentage Points By Cuts in Personal Income Tax Rates *

	<u>Real GDP Growth</u>			<u>Government Budget Balance as Percentage of GDP</u>			<u>Unemployment Rate</u>			<u>Inflation Rate: CPI</u>			<u>Current Account Balance (\$ billion)</u>		
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
United States	0.1	0.1	0.1	0.0	0.1	0.2	0.0	-0.1	-0.1	0.0	0.1	0.2	1.4	4.5	9.0
Canada	0.2	0.3	0.3	0.1	0.3	0.5	0.0	-0.1	-0.2	0.1	0.3	0.6	0.2	0.6	1.3
Japan	0.2	0.4	0.6	0.0	0.1	0.2	0.0	0.0	0.0	0.0	0.1	0.2	1.0	3.0	6.3
West Germany	1.0	2.0	2.0	-1.1	-1.5	-2.0	-0.4	-1.2	-2.1	-1.1	-1.5	-1.5	-2.8	-8.4	-14.2
France	1.0	2.0	2.0	-0.6	-0.2	-0.8	-0.6	-1.5	-2.8	-2.6	-0.8	-3.6	-0.7	-2.7	-5.3
United Kingdom	1.0	2.0	2.0	-0.9	-2.2	-3.9	-0.3	-0.9	-1.7	-0.5	-1.4	-1.9	-1.9	-6.3	-10.7
Italy	1.0	2.0	2.0	-0.2	0.8	2.3	-0.2	-0.8	-1.5	-0.8	-0.7	-0.5	0.0	-0.5	-0.9
Smaller Developed Countries	1.0	2.0	2.0	-0.5	-0.5	-0.6	0.0	-0.4	-0.9	0.1	0.7	0.6	0.5	0.1	-1.6
Western Europe	1.0	2.0	2.0	-0.7	-0.7	-0.9	-0.3	-0.9	-1.7	-1.0	-0.5	-1.2	-5.0	-17.7	-32.6
OECD	0.5	0.9	0.9	-0.2	-0.2	-0.3	-0.1	-0.4	-0.8	-0.3	0.0	-0.3	-2.4	-9.6	-16.2

* Unless otherwise indicated, all data are percentage point changes from baseline.

Table 2

Simulation 2: All West European Countries Raise Growth
One Percentage Point By Cuts in Personal Income Tax Rates*

	<u>Real GDP Growth</u>			<u>Government Budget Balance as Percentage of GDP</u>			<u>Unemployment Rate</u>			<u>Inflation Rate: CPI</u>			<u>Current Account Balance (\$ billion)</u>		
	1985	1986	1987	1985	1986	1987	1985	1986	1987	1985	1986	1987	1985	1986	1987
United States	0.0	0.1	0.1	0.0	0.1	0.1	0.0	0.0	-0.1	0.0	0.0	0.1	0.8	2.4	4.7
Canada	0.1	0.2	0.2	0.1	0.1	0.2	0.0	0.0	-0.1	0.0	0.2	0.3	0.1	0.3	0.7
Japan	0.1	0.2	0.3	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.5	1.5	3.1
West Germany	0.5	1.0	1.0	-0.5	-0.8	-1.0	-0.2	-0.6	-1.0	-0.5	-0.7	-0.7	-1.4	-4.1	-7.0
France	0.5	1.0	1.0	-0.3	-0.1	-0.4	-0.3	-0.7	-1.4	-1.3	-0.3	-1.9	-0.4	-1.3	-2.6
United Kingdom	0.5	1.0	1.0	-0.4	-1.1	-2.0	-0.1	-0.5	-0.9	-0.3	-0.7	-1.0	-0.9	-3.1	-5.3
Italy	0.5	1.0	1.0	-0.1	0.5	1.3	-0.1	-0.4	-0.7	-0.4	-0.4	-0.3	0.1	-0.1	-0.3
Smaller Developed Countries	0.5	1.0	1.0	-0.3	-0.3	-0.3	0.0	-0.2	-0.5	0.1	0.3	0.3	0.3	0.1	-0.8
Western Europe	0.5	1.0	1.0	-0.3	-0.4	-0.5	-0.1	-0.4	-0.9	-0.5	-0.3	-0.6	-2.4	-8.6	-16.0
OECD	0.2	0.5	0.5	-0.1	-0.1	-0.2	-0.1	-0.2	-0.4	-0.2	0.0	-0.1	-0.9	-4.4	-7.7

* Unless otherwise indicated, all data are percentage point changes from baseline.

Table 3

Simulation 4: Big Four West European Countries Raise Growth
One Percentage Point By Cuts in Personal Income Tax Rates*

	<u>Real GDP Growth</u>			<u>Government Budget Balance as Percentage of GDP</u>			<u>Unemployment Rate</u>			<u>Inflation Rate: CPI</u>			<u>Current Account Balance (\$ billion)</u>		
	1985	1986	1987	1985	1986	1987	1985	1986	1987	1985	1986	1987	1985	1986	1987
United States	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.7	2.0	3.9
Canada	0.1	0.1	0.1	0.0	0.1	0.2	0.0	0.0	-0.1	0.0	0.1	0.2	0.1	0.3	0.6
Japan	0.1	0.1	0.2	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.4	1.2	2.6
West Germany	0.5	1.0	1.0	-0.6	-1.1	-1.6	-0.2	-0.7	-1.2	-0.6	-1.0	-1.1	-1.7	-5.2	-9.3
France	0.5	1.0	1.0	-0.4	-0.1	-0.5	-0.3	-0.8	-1.4	-1.5	-0.4	-2.1	-0.5	-1.8	-3.8
United Kingdom	0.5	1.0	1.0	-0.5	-1.3	-2.4	-0.1	-0.5	-0.9	-0.3	-0.8	-1.2	-1.0	-3.4	-6.0
Italy	0.5	1.0	1.0	-0.1	0.4	1.1	-0.1	-0.4	-0.7	-0.5	-0.5	-0.5	0.1	-0.3	-0.8
Smaller Developed Countries	0.2	0.3	0.3	0.1	0.4	0.6	0.0	-0.1	-0.1	0.1	0.2	0.2	1.7	4.9	9.0
Western Europe	0.4	0.8	0.8	-0.2	-0.2	-0.4	-0.1	-0.4	-0.8	-0.5	-0.4	-0.8	-1.7	-6.4	-11.7
OECD	0.2	0.3	0.3	-0.1	-0.1	-0.1	-0.1	-0.2	-0.3	-0.2	-0.1	-0.3	-0.3	-2.3	-3.8

* Unless otherwise indicated, all data are percentage point changes from baseline.

Table 4

Simulation 5: Big Four West European Countries Raise Growth
One Percentage Point By Equal Combination of Cuts in Personal
Income Tax Rates and Cuts in Business Taxes*

	<u>Real GDP Growth</u>			<u>Government Budget Balance as Percentage of GDP</u>			<u>Unemployment Rate</u>			<u>Inflation Rate: CPI</u>			<u>Current Account Balance (\$ billion)</u>		
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
United States	0.0	0.1	0.1	0.0	0.1	0.1	0.0	0.0	-0.1	0.0	0.0	0.1	0.8	2.4	4.5
Canada	0.1	0.1	0.1	0.0	0.1	0.2	0.0	0.0	-0.1	0.0	0.1	0.3	0.1	0.3	0.6
Japan	0.1	0.2	0.2	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.3	1.1	2.4
West Germany	0.5	1.0	1.0	-0.3	-0.5	-0.4	-0.1	-0.2	-0.4	0.1	0.3	0.4	-1.8	-5.9	-10.4
France	0.5	1.0	1.0	-0.8	-2.0	-2.9	-0.2	-0.6	-0.9	0.1	0.5	0.9	-0.5	-1.9	-3.6
United Kingdom	0.5	1.0	1.0	-0.4	-1.2	-2.2	-0.1	-0.4	-0.8	0.1	0.4	0.7	-1.6	-5.1	-9.0
Italy	0.5	1.0	1.0	0.1	0.8	1.9	-0.1	-0.4	-0.8	0.1	0.2	0.1	-0.2	-0.7	-1.2
Smaller Developed Countries	0.1	0.3	0.2	0.1	0.2	0.4	0.0	0.0	-0.1	0.2	0.4	0.4	1.7	4.8	7.6
Western Europe	0.4	0.8	0.8	-0.2	-0.3	-0.3	-0.1	-0.3	-0.5	0.1	0.4	0.5	-2.6	-9.3	-17.4
OECD	0.2	0.4	0.3	-0.1	-0.1	-0.1	0.0	-0.1	-0.2	0.1	0.3	0.4	-1.2	-5.1	-9.1

* Unless otherwise indicated, all data are percentage point changes from baseline.

Table 5

Simulation 3: Big Four West European Countries Raise Growth
One Percentage Point By Equal Combination of Cuts in Personal
Income Tax Rates and Increases in Government Spending*

	<u>Real GDP Growth</u>			<u>Government Budget Balance as Percentage of GDP</u>			<u>Unemployment Rate</u>			<u>Inflation Rate: CPI</u>			<u>Current Account Balance (\$ billion)</u>		
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
United States	0.0	0.1	0.1	0.0	0.1	0.1	0.0	0.0	-0.1	0.0	0.0	0.1	0.8	2.4	4.6
Canada	0.1	0.2	0.2	0.0	0.1	0.2	0.0	0.0	-0.1	0.0	0.1	0.3	0.1	0.3	0.7
Japan	0.1	0.2	0.3	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.4	1.4	2.8
West Germany	0.5	1.0	1.0	-0.4	-0.6	-0.8	-0.1	-0.4	-0.7	-0.2	-0.3	-0.2	-1.9	-5.8	-10.1
France	0.5	1.0	1.0	-0.3	-0.7	-1.5	-0.2	-0.7	-1.2	-0.5	0.1	0.1	-0.6	-2.1	-4.1
United Kingdom	0.5	1.0	1.0	-0.3	-0.9	-1.6	-0.1	-0.5	-0.8	-0.1	-0.1	0.1	-1.4	-4.6	-8.1
Italy	0.5	1.0	1.0	0.2	1.1	2.3	-0.1	-0.4	-0.8	0.0	0.3	0.3	-0.1	-0.6	-1.1
Smaller Developed Countries	0.1	0.3	0.2	0.1	0.2	0.4	0.0	0.0	-0.1	0.2	0.4	0.4	1.8	4.9	7.8
Western Europe	0.4	0.8	0.8	-0.1	-0.1	-0.1	-0.1	-0.3	-0.6	-0.1	0.2	0.2	-2.3	-8.7	-16.3
OECD	0.2	0.4	0.3	0.0	0.0	0.0	0.0	-0.2	-0.3	0.0	0.2	0.2	-0.8	-4.1	-7.4

* Unless otherwise indicated, all data are percentage point changes from baseline.

Table 6

Simulation 6: The United Kingdom and West Germany Raise Growth
One Percentage Point By Cuts in Personal Income Tax Rates*

	<u>Real GDP Growth</u>			<u>Government Budget Balance as Percentage of GDP</u>			<u>Unemployment Rate</u>			<u>Inflation Rate: CPI</u>			<u>Current Account Balance (\$ billion)</u>		
	1985	1986	1987	1985	1986	1987	1985	1986	1987	1985	1986	1987	1985	1986	1987
United States	0.0	0.1	0.0	0.0	0.0	0.1	0.0	0.0	-0.1	0.0	0.0	0.1	0.5	1.8	3.8
Canada	0.1	0.1	0.1	0.0	0.1	0.2	0.0	0.0	-0.1	0.1	0.2	0.3	0.1	0.3	0.6
Japan	0.1	0.2	0.2	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.5	1.5	2.9
West Germany	0.5	1.0	1.0	-0.1	-1.6	-2.3	-0.3	-0.8	-1.5	-0.8	-1.3	1.6	-2.3	-6.8	-11.8
France	0.2	0.5	0.6	0.1	0.3	0.7	0.0	-0.2	-0.4	-0.1	0.0	0.1	0.5	0.9	1.3
United Kingdom	0.5	1.0	1.0	-0.5	-1.4	-2.5	-0.1	-0.5	-0.9	-0.3	-0.9	-1.3	-1.2	-3.8	-6.6
Italy	0.2	0.6	0.8	0.2	0.9	1.9	-0.1	-0.2	-0.5	0.1	0.1	0.2	0.2	0.4	0.5
Smaller Developed Countries	0.1	0.2	0.2	0.1	0.2	0.4	0.0	0.0	-0.1	0.2	0.4	0.4	1.6	4.1	7.0
Western Europe	0.3	0.7	0.7	-0.2	-0.2	-0.3	-0.1	-0.3	-0.6	-0.1	-0.1	-0.1	-1.4	-5.6	-10.3
OECD	0.1	0.3	0.3	-0.1	-0.1	-0.1	0.0	-0.1	-0.3	0.0	0.0	0.0	-0.2	-1.7	-2.3

* Unless otherwise indicated, all data are percentage point changes from baseline.

Table 7

Simulation 7: The United Kingdom and West Germany Advance
Tax Cuts Planned for 1985 and 1987*

	<u>Real GDP Growth</u>			<u>Government Budget Balance as Percentage of GDP</u>			<u>Unemployment Rate</u>			<u>Inflation Rate: CPI</u>			<u>Current Account Balance (\$ billion)</u>		
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
United States	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	1.1	2.0
Canada	0.0	0.1	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.2	0.1	0.2	0.3
Japan	0.1	0.1	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.3	1.0	1.6
West Germany	0.4	0.7	0.4	-0.7	-1.3	-1.3	-0.2	-0.6	-0.9	-0.6	-1.0	-0.7	-1.7	-5.3	-7.5
France	0.1	0.4	0.3	0.1	0.2	0.4	0.0	-0.2	-0.3	-0.1	-0.1	0.1	0.3	0.5	0.4
United Kingdom	0.3	0.4	0.2	-0.2	-0.5	-0.6	-0.1	-0.2	-0.3	-0.2	-0.3	-0.2	-0.6	-1.5	-1.6
Italy	0.2	0.4	0.4	0.1	0.6	1.1	0.0	-0.1	-0.3	0.0	0.1	0.1	0.1	0.2	0.3
Smaller Developed Countries	0.1	0.2	0.0	0.0	0.1	0.2	0.0	0.0	0.0	0.1	0.3	0.2	1.1	2.7	3.5
Western Europe	0.2	0.4	0.2	-0.1	-0.2	-0.1	-0.1	-0.2	-0.4	-0.1	-0.1	0.0	-1.0	-3.6	-5.3
OECD	0.1	0.2	0.1	0.0	-0.1	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0	-0.2	-1.0	-0.9

* Unless otherwise indicated, all data are percentage point changes from baseline.